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OO RUEHIK RUEHLN RUEHPOD RUEHVK RUEHYG
DE RUEHKV #3058/01 3471037
ZNR UUUUU ZZH
O 131037Z DEC 07
FM AMEMBASSY KYIV
TO RUEHC/SECSTATE WASHDC IMMEDIATE 4557
INFO RHEBAAA/DEPARTMENT OF ENERGY WASHDC
RUCPDOG/DEPT OF COMMERCE WASHDC
RUCNCIS/CIS COLLECTIVE
RUEHZG/NATO EU COLLECTIVE

UNCLAS SECTION 01 OF 03 KYIV 003058

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DEPT FOR EUR/UMB,EB/ESC/IEC - GALLOGLY/WRIGHT
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E.O. 12958: N/A

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SUBJECT: UKRAINE: NAFTOHAZ'S FINANCIAL UNCERTAINTY A GROWING
CONCERN

REF: A) KYIV 2611

B) KYIV 2939

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1. (U) Summary. NaftoHaz Ukraine, the state-owned gas and oil company that accounts for 10 percent of GDP, could well be close to bankruptcy. NaftoHaz's losses and debts have mounted as the GOU continues to set domestic gas prices that are too low to cover the rising cost of gas imports, and because middlemen RosUkrEnergo and UkrHazEnergo are siphoning off much of the cash flow in Ukraine's gas market, leaving NaftoHaz with the loss-making business of selling gas to retail distributors and municipal heating companies with poor payment discipline. International investors could demand early repayment of a Eurobond issue, and the respected rating agency Fitch may withdraw its ratings for NaftoHaz if the company does not publish its already overdue 2006 financial statements by the end of the year. It seems likely that action will be needed to avoid bankruptcy. Such action could involve the GOU providing significant subsidies to NaftoHaz, selling off pipeline assets (which Gazprom has long expressed interest in purchasing), or privatization of other assets. Due to its strategic role, the GOU is unlikely to allow NaftoHaz to go bankrupt, but the cost of avoidance may be high. End summary.

The Role of NaftoHaz

2. (U) NaftoHaz (Naftogaz in Russian transliteration) is a vertically-integrated oil and gas company. It (along with its majority-owned subsidiary UkrNafta) accounts for over 96 percent of domestic oil and gas production and operates Ukraine's gas pipeline network, which provides transit to approximately 80 percent of Russia's Europe-bound gas. In addition, it supplies natural gas and crude oil to domestic utilities at low tariffs set by regulators. Entirely state-owned, it is of considerable strategic importance to Ukraine, generating approximately 10 percent of GDP and employing approximately 170,000 people.

Recent Changes in Gas Market and Impact on NaftoHaz's Bottom Line

3. (SBU) Much of the company's operations, and in particular its financial health, remain opaque as a result of mismanagement, corruption and intentional obfuscation. The company has also been on the losing end of various parties' efforts to exert control over Ukraine's gas market and to pocket some of the significant cash flows associated with the gas trade. RosUkrEnergo and its predecessor EuralTransGas have cut off NaftoHaz from direct commercial relations with either Gazprom or central

Asian suppliers. The creation of UkrHazEnergo, as a result of the 2005/6 gas crisis, stripped NaftoHaz of the lucrative gas supply to industrial customers, leaving NaftoHaz with the unprofitable business with distributors and municipal heating providers that is marked by poor payment discipline, inefficient and corrupt regional distribution companies and politically determined retail prices that, despite increases in recent years, are still too low to cover costs. (Note: Although NaftoHaz owns 50 percent of UkrHazEnergo - RosUkrEnergo owns the other half - it is widely recognized that RosUkrEnergo calls the shots at UkrHazEnergo. Significantly, UkrHazEnergo has not paid its 2006 dividends to NaftoHaz. End note). At the same time as these structural shifts were hitting at NaftoHaz's profitability, prices for imported gas increased from \$50 per thousand cubic meters (tcm) in 2005 to \$135/tcm this year, and are scheduled to rise to \$179.5/tcm in 2008. Consumer nonpayment has increased with the rises in gas prices. In late 2006 and early 2007, Yuliya Tymoshenko's BYuT party even politicized the price increases, encouraging consumers not to pay.

Financial Situation is Precarious

14. (SBU) By all accounts, the financial situation at NaftoHaz is precarious. The company has not yet published its financial figures for 2006. Gas transit still appears to be profitable, but the company's domestic gas sales business is accumulating losses, liquidity appears to be tight, and its debts are mounting. Ukraine's State Tax Administration claims that, as of November 1, NaftoHaz owes taxes of UAH 2.3 billion (about \$450 million). NaftoHaz also received tax deferrals in 2006 and 2007. One analyst report quotes acting Prime Minister Yanukovych as stating that NaftoHaz's total losses for 2006 may amount to \$1.5 billion. According to analysts' reports, NaftoHaz has about \$2.5 billion in debts. Of the total, \$500 million is in Eurobonds and \$1.6 billion in loans from foreign banks. The rest takes the forms of loans from

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domestic banks. The company has reported that it earned \$60 million after taxes in the first half of 2007, which would indicate a significant improvement over the first half of 2006.

15. (SBU) A NaftoHaz spokesman blamed the delay in publishing the 2006 figures on the "machinations" of its previous CEO. However, regional press reports suggest that there may be other reasons. According to the press, the audit for 2006, prepared by the auditing firm Ernst & Young, will not be signed until parliament provides a guarantee to the company. This is because the auditors reportedly refused to certify that NaftoHaz otherwise was a "going concern," meaning that it could be expected to continue normal operations for the following year. NaftoHaz management is telling analysts and creditors that it expects the Rada to approve a \$1 billion subsidy for the company to partially offset the losses associated with selling gas at below cost to utilities. The subsidy may be in cash, or through tax offsets. It is unclear, however, whether the new parliament will actually be prepared to support the company.

Eurobond Holders May Soon Recall Their Bonds

16. (SBU) It is particularly doubtful that the Rada will approve of financial support by the end of the year. If it doesn't, and if NaftoHaz does not publish its 2006 data by December 31, holders of its Eurobond issue due for repayment in 2009 could ask for their money back. According to the conditions of the Eurobond, NaftoHaz had to publish the 2006 financial figures by August 31. Failure to do so gives the bondholders the right to immediately redeem the bonds. Bondholders usually have the option of waiving this right if the borrower pays an additional fee, but NaftoHaz reportedly so far has refused. At a November 14 meeting in London, bondholders agreed to give NaftoHaz until December 31 to publish the 2006 financial figures.

Fitch Threatens to Withdraw Ratings

17. (SBU) The international rating agency Fitch has even threatened

to withdraw its ratings for NaftoHaz because of the delay in publishing the 2006 figures. Withdrawal is merited when Fitch believes it no longer has access to adequate information to credibly maintain the ratings. Fitch has yet to actually pull the ratings, as it has reportedly received assurances from NaftoHaz that the financial figures will be forthcoming. On October 15, however, Fitch placed NaftoHaz's ratings on so-called "rating watch negative," indicating that it may soon downgrade the company's ratings. Fitch justified the move because of NaftoHaz's failure to publish its 2006 figures in a timely matter, and after NaftoHaz was suddenly confronted with an additional debt of \$729 million to Gazprom shortly after the September 30 parliamentary elections. The debt issue has been solved in the meantime (ref A). A NaftoHaz representative told the press that it does not expect negative fallout from a possible downgrade since foreign investors are aware of the reason for the delay in submitting the 2006 financial report.

18. (SBU) NaftoHaz's current ratings are in the non-investment grade category (also known as junk bonds). Fitch last downgraded the company's ratings in 2006 as a result of the company's deteriorating financial situation in the wake of the gas price hikes of early 2006. The main ratings now stand in the single B category, one of the lower ratings granted by the well-respected rating agency. Later in 2006, Fitch indicated it might reduce its ratings of NaftoHaz further, yet took no action after NaftoHaz presented plans to develop its remaining areas of business (domestic gas production, transit, and domestic gas sales). At that time, the Ministry of Fuels and Energy reportedly wrote a letter to NaftoHaz's bank lenders stating that it will back the company by supporting any actions aimed at improving NaftoHaz's financial position and preventing bankruptcy.

Comment: The Future Looks Bleak

19. (SBU) Looking forward, NaftoHaz's financial prospects remain bleak. With NaftoHaz's limited ability to pass on higher costs to consumers, the recently announced price hikes for imported gas in 2008 will likely increase the losses in the company's domestic business. A failure to publish 2006 financial results by the end of this year could cause Eurobond creditors to call their bonds or Fitch to withdraw its rating, either of which would negatively impact NaftoHaz's ability to borrow in the future, or to refinance debts coming due in 2008 and beyond. Default is a possibility, as it is not clear NaftoHaz has the funds to pay if bondholders demand

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immediate payment. These scenarios could even have a negative impact on the creditworthiness of Ukraine as a whole because NaftoHaz is fully owned by the state. The underlying fundamentals of the company are difficult to assess as the company continues its policies of financial non-transparency. It seems likely that GOU action will be needed to avoid bankruptcy. Such action could involve the GOU providing significant subsidies or selling off of other assets. Gazprom has long been interested in purchasing or taking operational control of Ukraine's transit pipelines. Current Ukrainian law forbids any sale or transfer of control for the pipelines, but under the pressure of bankruptcy, it is not absolutely certain the GOU will hold to this policy. Due to its strategic role, the GOU is unlikely to allow NaftoHaz to go bankrupt, but the cost of avoiding bankruptcy may be high. End comment.
TAYLOR